BRIEF IN SUPPORT OF PETITION.

Questions Presented, Statement of Case, etc.

The statement of questions presented, the statement of the case, and the statutes involved will be found in the petition.

Specification of Errors and Summary of Argument.

1. The Circuit Court of Appeals erred in construing section 102, Revenue Act of 1934, as imposing corporate surtax liability without a finding that the purpose of preventing the imposition of individual surtaxes on shareholders was a substantial factor in inducing accumulations by the corporation. Upon the introduction of positive evidence as to the actual purposes of the accumulation, the *prima facie* effect given by section 102(b) to a finding of accumulation beyond reasonable business needs disappears from the case.

2. The Circuit Court of Appeals erred in refusing to hold that the Tax Court in the present case made no finding that the purpose of preventing the imposition of individual surtaxes was a substantial factor in inducing the accumulations of the petitioner penalized by the Commissioner, and no such finding would have been warranted.

Argument.

Petitioner maintains that the lower courts erroneously construed Section 102 as imposing penal surtax liability if any "taint" of the condemned purpose existed, even though such purpose was not a substantial inducing cause of the accumulations of profits.

Petitioner did not attack any of the subsidiary findings of fact of the Tax Court. On appeal it did not argue that the finding that profits were accumulated beyond the reasonable needs of the business (R. 73) could not be treated as supported by substantial evidence, although believing such finding to be incorrect. What petitioner maintained, and maintains, is that such finding is not decisive of surtax liability under section 102.

Petitioner maintains that, because of the Tax Court's erroneous construction of the statute, its finding as to purpose, although couched in the language of the statute (R. 73) was not in fact a finding that the purpose of preventing the imposition of the surtax on shareholders was a substantial or inducing motive of petitioner's accumulations. Lacking a proper finding of the fact essential to liability, the Circuit Court of Appeals should have reversed the decision of the Tax Court. The lack of this essential finding as to purpose is not supplied by the finding that profits were accumulated beyond reasonable business needs, or the fact that greater distributions would necessarily have resulted in greater current surtaxes on shareholders. Those facts alone afford no basis for imposing liability where there is positive, uncontradicted testimony that the purposes inducing the accumulations were wholly other than a purpose of preventing surtaxes on shareholders.

I.

The Circuit Court of Appeals erred in construing Section 102, Revenue Act of 1934, as imposing corporate surtax liability in the absence of a finding that the purpose of preventing the imposition of individual surtaxes on shareholders was a substantial factor in inducing accumulations by the corporation. Upon the introduction of positive evidence as to the actual purposes of the accumulation, the *prima facie* effect given by Section 102(b) to a finding of accumulation beyond reasonable business needs disappears from the case.

Section 102 imposes liability only where the accumulation is "for the purpose of preventing the imposition of the surtax" upon the corporation's shareholders. This Court said in *Helvering* v. *National Grocery Co.,* 304 U. S. 282, 289 (1938), "The existence of the defined purpose is a condition precedent to the imposition of the tax liability * * *."

Although the statute refers to "*the* purpose", petitioner does not contend that liability is conditioned on the condemned purpose being the *sole* purpose inducing the accumulation. Obviously, however, there must be a definite, substantial, causal connection between the purpose and the act. The mere fact that there is an accumulation and resulting payment currently by stockholders of less surtaxes is not sufficient. *Effect* must not be confused with *purpose.* Purpose is defined as "That which one sets before himself as an object to be attained; the end or aim to be kept in view in any plan, measure, exertion, or operation." (Webster's New International Dictionary, 2nd Ed.) By the plain terms of the statute liability is imposed only if the purpose of preventing the

imposition of surtaxes on shareholders was the inducing cause of the accumulations. No other test of liability is prescribed by Section 102.

Where more than one purpose may to some measure operate, the extent to which the purpose specified as a basis for tax liability must come into play is indicated by the decision of this Court in *United States* v. *Wells,* 283, U. S. 102 (1931), which also involved a tax statute making liability dependent on the purpose or state of mind of a person. The statute there construed (now Section 811(c) of the Internal Revenue Code) included in the gross estate of a decedent, for purposes of taxation, any property "of which the decedent has at any time made a transfer * * * in contemplation of * * * death." This Court stated that "The question, necessarily, is as to the state of mind of the donor" (p. 117), and that "the words 'in contemplation of death' mean that the thought of death is the impelling cause of the transfer * * *" (p. 118). The Court referred to the motive or purpose required for liability as "a controlling motive" (p. 118) or "inducing cause" (p. 119). It said the gratification of desires associated with life "may be a more compelling motive than any thought of death", and concluded (p. 119):

> "There is no escape from the necessity of carefully scrutinizing the circumstances of each case to detect the dominant motive of the donor in the light of his bodily and mental condition, and thus give effect to the manifest purpose of the statute."

In *Farmers' Loan & Trust Co.* v. *Bowers,* 98 F. (2d) 794 (C. C. A. 2d, 1938), certiorari denied 306 U. S. 648, the Circuit Court of Appeals held that whether or not the desire to avoid estate taxes had to be the dominant or controlling motive, it was at least necessary that the death

motive be important and substantial. It affirmed the District Court's decision because "the evidence demonstrated that avoidance of estate taxes was a substantial motive for the settlor's action." See Paul, *Estate and Gift Taxation*, Sections 6.07 to 6.14.

The phrase "in contemplation" in Section 811(c) of the Internal Revenue Code is not as strong as the phrase "for the purpose" in Section 102 of the Revenue Act. Since in the case of the former the death motive must be the "inducing," "impelling," or "controlling" cause of the transfer, it seems clear that in the case of the latter the avoidance of surtaxes must also be the inducing, compelling or controlling cause of the accumulation of profits. It would not appear that this Court, in its opinion in the *Chicago Stockyards* case, *supra,* intended to lay down any different principle with respect to Section 102 when it said (p. 699):

> "A corporate practice adopted for mere convenience or other reasons, and without tax significance when adopted, may have been continued with the additional motive of avoiding surtax on the stockholders. The Board's conclusion may justifiably have been reached in the view that, whatever the motive when the practice of accumulation was adopted, the purpose of avoiding surtax induced, or aided in inducing, the continuance of the practice."

This would seem to mean merely that a practice originally instituted without regard to the condemned purpose may be found to have been continued because of the coming into play of that purpose. It affirms that there must be a causal connection between the condemned purpose and the act. It is submitted that if the measure of that connection is not dominance, as laid down in the *Wells* case, the specified

purpose must at the very least be a material or substantial cause of the action taken.

The construction of the statute adopted in the decision below (See pp. 18-19 *supra*) is clearly inconsistent in principle with the decision in the *Wells* case. If liability can be imposed only if the purpose specified in the statute is the *dominant* purpose, as the *Wells* case indicates, the holding of the Circuit Court of Appeals is in direct conflict with the *Wells* case. Even if the purpose specified need be merely a substantial inducing cause, though not dominant, the construction of the statute adopted below is wrong because not even this minimum causal connection is required under the Tax Court's erroneous construction of the statute which the Circuit Court of Appeals refused to correct.

Subdivision (b) of Section 102 does not have the effect of authorizing the imposition of liability without a finding that the purpose specified in the statute was a substantial cause of the accumulations, where the taxpayer goes forward with the evidence and shows that the impelling motive was other than that of avoiding surtaxes on shareholders. Subdivision (b) of Section 102 provides:

> "The fact * * * that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to avoid surtax."

Under this provision, accumulation beyond reasonable business needs, *if unexplained,* can be treated as the basis of liability—this not because proven facts actually establish the existence of the condemned purpose, but merely because of the failure of those who know the facts to introduce evidence establishing the actual purpose. Wigmore on Evidence (3rd Ed., 1940) Sec. 1356. The mere fact of accumulation beyond reasonable business needs does not

logically tend to prove that the purpose of the accumulation was that of avoiding surtaxes, and in no way negatives the impelling force of a wholly different purpose. This fact gives equal support to inconsistent inferences and does not prove *why* the accumulations were made.

Section 102(b) creates a purely artificial statutory nexus between the two facts. When evidence is introduced as to the actual purpose inducing the accumulation, the statutory presumption that accumulation beyond reasonable needs is *prima facie* evidence of the existence of the condemned purpose disappears as completely as if it had never existed. Wigmore on Evidence (3rd Ed., 1940) Sec. 2491, *Mobile, J. & K. C. R. R.* v. *Turnipseed,* 219 U. S. 35, 43 (1910); *Western & Atlantic Railroad* v. *Henderson,* 279 U. S. 639 (1929); *Griffin* v. *The State,* 142 Ga. 636, 639 (1914).

Hemphill Schools, Inc. v. *Commissioner,* 137 F. (2d) 961 (C. C. A. 9th, 1943), shows the limited effect of artificial presumptions. In that case, which arose under Section 102, the sole issue was whether there had been an accumulation beyond the reasonable needs of the business, the taxpayer making no contention that there were other legitimate reasons for the accumulation. The Circuit Court of Appeals reversed the Tax Court for having given weight as evidence to the presumption of the correctness of the determination of the Commissioner on that issue, after affirmative evidence had been introduced by the taxpayer. The Court said:

> "Thus, if no evidence had had been produced, the Board would have had to accept the determination; for, until evidence was produced, the determination was presumed to be correct [citing cases].
>
> "Evidence *was* produced. Some of the evidence produced by petitioner tended to prove that its gains

> and profits were not permitted to accumulate beyond the reasonable needs of its business. Evidence having been so produced, the presumption ceased, and thenceforth the issue depended 'wholly upon the evidence' [citing cases]. It thus became the duty of the Board to find from the evidence, and from it alone, whether petitioner's gains and profits were permitted to accumulate beyond the reasonable needs of its business. No such finding was made. Instead, the Board treated the presumption (which no longer existed) as if it were evidence, weighed it against petitioner's evidence and concluded that petitioner's evidence did not 'overcome' it."

Petitioner concedes that the *prima facie* evidence is not dissolved by a mere categorical denial of the existence of the condemned purpose. Where, however, the taxpayer introduces affirmative, forceful and undisputed evidence of an actual purpose wholly different from the prevention of individual surtaxes on shareholders, it is submitted that this evidence must be controlling, in the absence of affirmative evidence (as distinguished from the artificial presumption) to the contrary.

The lower courts did not so apply the provision of Section 102(b). The Tax Court said "The *prima facie* case is an affirmative one created in respondent's favor" (R. 89). The Circuit Court of Appeals apparently also regarded the statutory presumption as evidence to be weighed by the Tax Court in reaching its conclusion (R. 374). The clear implication is that where in the judgment of the Tax Court earnings are accumulated beyond reasonable business needs, the Tax Court, because of the statutory presumption, need not find from the evidence that the purpose specified in the statute motivated the accumulations, but can impose liability, no matter what motives or purposes are actually proved, unless convinced that the pur-

pose specified in the statute was wholly and completely absent.

Such a view misconceives the effect of subdivision (b) of Section 102 and conflicts in principle with the decision of the Circuit Court of Appeals for the 9th Circuit in the *Hemphill Schools, Inc.* case, *supra.* Section 102 (b) does not authorize the imposition of the tax merely because of an accumulation beyond reasonable business needs where the taxpayer comes forward with affirmative evidence that the impelling motive was wholly other than that of surtax avoidance.

The view of the courts below would substantially convert the tax under Section 102 into an entirely different tax imposed on accumulation of profits beyond the reasonable needs of the business, regardless of purpose. Congress might have imposed a tax on accumulations of profits beyond the reasonable needs of the corporation's business, or it might even have imposed a tax on total accumulations if any part thereof was beyond reasonable business needs, but it is clear that it did not do so in Section 102. This tax is limited to "corporations *improperly* accumulating surplus," the impropriety justifying imposition of the tax being an accumulation "for the purpose of preventing the imposition of the surtax upon its shareholders * * *."

The tax under Section 102, being dependent on purpose, differs radically in nature from the *undistributed profits* tax imposed by Section 14, Revenue Act of 1936, the tax which caused the petitioner to divert from its established dividend practice and declare extra dividends in 1936 and 1937. Unlike the tax under Section 102, that tax was measured by undistributed income at rates ranging up to 27%, without regard to the purpose of the accumulations. The Revenue Act of 1936 also continued in effect the penalty surtax under Section 102 (the same tax as that here in-

volved), with a rate reduction of 10% to corporations held to be subject to both taxes (Section 102(a)(1) and (2)). Since both provisions were in the 1936 Act, it is apparent that their purpose and incidence were different. *U. S.* v. *Hutcheson*, 312 U. S. 219 (1941).

The tax on *undistributed profits,* first imposed by the Revenue Act of 1936, met with widespread protest. This led to the virtual abandonment of such a tax in Section 13, Revenue Act of 1938. The last vestige was eliminated by Section 201, Revenue Act of 1939.

It could not possibly have been the intention of Congress that Section 102, which was continued in effect throughout this period, should be applied for all practical purposes as if it were the different and later repealed tax imposed on *undistributed profits,* irrespective of purpose. Yet that is precisely the result of the decision below. Under that decision the statute is applied as follows: First, the Tax Court, substituting its judgment for that of the directors, makes a finding that there was an accumulation beyond the reasonable needs of the business. This finding is virtually non-reviewable, inasmuch as in every such case the record will contain balance sheets, income statements and the like which might be deemed "some evidence". Second, even though the taxpayer comes forward with evidence as to the actual purposes of the accumulation, the Tax Court is permitted to make a finding of the condemned purpose *merely on the basis of the accumulation itself,* without any determination on the affirmative evidence that the accumulation was actually motivated by surtax considerations. Thus, under the decision below, a fact which Congress carefully provided should be but *prima facie* evidence, putting on the taxpayer merely the burden of going forward with evidence to the contrary, is made practically conclusive of liability.

Under this construction of the statute the only safe procedure which directors can follow is to distribute earnings to a point where reasonable men cannot differ as to the necessity for keeping the remainder in the business. Accumulation of any greater amount cannot safely be made even though in the judgment of the directors it is desirable for the business. No accumulation can safely be made for the purpose of protecting rights of stockholders under perfectly legitimate contracts, or for any legitimate purpose other than business needs. Obviously proof of actual purposes cannot be relied upon as a defense if the Tax Court is to be permitted to find the existence of the condemned purpose on the basis of *prima facie* evidence even after the taxpayer has produced affirmative, undisputed evidence as to the actual purposes.

The decision below was thus based on fundamental errors of law in the construction and application of the statute, conflicting in principle with decisions of this Court and should therefore be reviewed by this Court.

II.

The Circuit Court of Appeals erred in refusing to hold that the Tax Court in the present case made no finding that the purpose of preventing the imposition of individual surtaxes was a substantial factor in inducing the accumulations by the petitioner penalized by the Commissioner, and no such finding would have been warranted.

The Tax Court in this case purported to find the ultimate fact as to purpose, essential to liability, that "petitioner was availed of for the purpose of preventing the imposition of

the surtax on its shareholders" (R. 73, 97). This finding, however, must be read in the light of the statements in its opinion (quoted, *supra*, p. 18). From these it clearly appears that the Tax Court erroneously believed that the statute authorized such a finding if there was "any taint of a purpose" to avoid surtaxes, or if the stockholders "allowed their purposes to stray" in that direction. The Tax Court believed that the taxpayer must show "complete innocence" and a "complete lack" and "absence" of the condemned purpose.

The Tax Court's finding, thus read in the light of its opinion, was not a finding that the condemned motive actually played a material or substantial part in causing the accumulations, or was an inducing or contributing cause, or that but for a purpose to avoid surtaxes petitioner in 1934 and 1935 would have changed the dividend policy it had theretofore followed from 1928 to 1933, without question by the Commissioner, and would have made greater distributions. The fact which the Tax Court regarded as supported by the preponderance of the evidence wholly apart from presumptions and burden of proof (R. 97), namely, that there was a "taint" and not a "complete lack" of a purpose to avoid surtaxes, was not the fact giving rise to liability under a proper construction of the statute.

Petitioner does not by any means concede that there was even a "taint" of the condemned purpose. Petitioner submits, however, that that is all the Tax Court actually found; that the finding essential for liability was that the condemned purpose played a material or substantial part in causing the accumulations; and that since the Tax Court omitted to make the finding required, the Circuit Court of

Appeals was not free to affirm the decision unless the omitted finding was compelled by the evidence. The Circuit Court of Appeals did not and could not on the record hold that there was any such compelling evidence.

The lack of a proper finding as to purpose, essential to liability under the statute, is not overcome by the Tax Court's finding in the present case of an accumulation beyond the reasonable needs of the business. Petitioner did not, on appeal, challenge that finding, although believing it to be unwarranted. That finding, however, merely required petitioner to go forward with the evidence and show affirmatively the purposes motivating the accumulations. This the petitioner did. Thereupon the *prima facie* effect of that finding as proof of purpose completely disappeared from the case.

The evidence before the Tax Court did not compel, and in fact would not warrant, a finding that a purpose of preventing the imposition of surtaxes on shareholders was a substantial or inducing cause of petitioner's dividend policy.

The evidence shows that in connection with the arms-length sale of stock in 1927 the stockholders, at the instance of the bankers, agreed with the Company to "waive" dividends up to $2.50 per share on 450,000 shares of stock. The bankers agreed to the provisions of the contract giving the stockholders the right to release the restricted shares from this waiver because they realized that such release could be effected only through the "conservation of earnings" and the building up of corporate earning power, and that this would protect and enhance the value of the shares they were selling to the public.

The 1927 contract did not expressly provide that no dividends (in addition to the annual dividend of $2.50 per share on the free shares) should be paid until the book value of the stock had been built up, but the inducement of obtaining

release of the restricted shares was calculated to have such an effect. The bankers knew who would control the dividend policy of the Company—they knew that the principal holders of the restricted shares would be the directors. They knew it would be in the interest of those directors to conserve the corporate assets and earnings so as to effect a release of the restricted shares. They relied on this motive rather than on an express provision in the contract restricting dividends.

Neither did the 1927 contract expressly provide that no dividend (in addition to the annual dividend of $2.50 a share on the free shares contemplated thereby) should be paid until all the restricted shares were released. The bankers, acting in the interest of the free stock, knew that the controlling stockholders would have a very strong inducement to limit dividends to $2.50 per share on the free shares and thereby increase the earnings of the Company to the levels necessary to release the restricted shares as rapidly as possible. They knew that, in the absence of unforeseen circumstances, the directors would never depart from such a policy.*

All the parties to the 1927 transaction realized that the Company's earnings could not be built up to the release levels of $5, or $6, or, eventually, $9 a share except by "conservation of earnings and working capital." They believed that the stipulated levels of earnings could be reached, but the Company concededly could not make any such profits on

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* The enactment of the undistributed profits tax (Section 14, Revenue Act of 1936) was an unforeseen circumstance which, in 1936 and 1937, diverted petitioner from its fixed dividend practice to the extent that additional distributions of $1.37½ per share were made on all stock outstanding (R. 57). This does not support an inference that petitioner's dividend practice was not actuated by the purpose of carrying out the 1927 contracts. That purpose would have been frustrated either by permitting the undistributed profits tax to be imposed or by making the extra distributions to stockholders, thus leaving no real choice but to make the extra distributions.

the capital it had in 1927. The only way in which it could increase its earnings to such levels was by keeping the earnings in excess of $2.50 a free share and (a) using as much as was practicable as additional working capital in the growing manufacturing business and (b) investing the remainder in securities, pending its absorption by the business, and adding the income from such investments to operating profits. The Company could not add to its capital except by accumulating earnings because it had agreed not to make any change in its capitalization until all its restricted shares were released. Under the contract, it could not put out an additional issue of stock (R. 282).

Under this set-up the controlling stockholders had the strongest possible motives, wholly independent of surtax considerations and entirely in accord with the welfare of the corporation, to follow the dividend practice which was established upon the recapitalization and sale of stock, was adhered to thereafter through 1933 without objection from the Commissioner, and was continued during the tax years in question. In view of these inducements it is clear that the practice which was followed was exactly the practice which would have been followed if there were no surtaxes at all on dividends to stockholders; that the corporation was not diverted by surtax considerations in the conduct of its affairs; and that the Government was not, because of consideration of stockholders' surtaxes, deprived of revenue which it otherwise would have received. In fact its tax revenues from the original stockholders were steadily increased as additional shares were released.

The Tax Court failed to give proper consideration to the over-all results, tax-wise, of the policy pursued. As indicating the purpose of that policy, its effect in any particular year must be viewed against the broader picture of

the entire operation. As the heading of the statute states, the penalty is imposed on "Corporations *Improperly* Accumulating Surplus." The impropriety rests in accumulations made to avoid "the surtax" on shareholders. This does not necessarily refer to the surtax for the current year, but to a course of conduct designed over a period to escape the impact of the system of surtaxes at progressive rates, by leaving in the corporation amounts which but for the surtax burden would normally have been distributed.

In the present case the dividends received by the old stockholders, and the surtaxes paid by them, steadily increased from year to year under the policy pursued (see pp. 14-16, *supra*). Those in control were using their best efforts and judgment to increase both corporate income and their individual incomes. Their efforts were highly successful. The Government shared greatly in their success through increased corporation and individual taxes. The results could not have been achieved if the Company had ceased to grow after 1927, or after 1933.

In summary, it is submitted that the uncontradicted evidence showed that the prevention of surtaxes on shareholders was not a "purpose" of the accumulations within the meaning of the statute. The saving of surtaxes was not, to paraphrase the definition of the word purpose, "that which the stockholders set before themselves as an object to be attained"; it was not "the end or aim kept in view in the plan of operation."

Petitioner's evidence was, of course, directed partly to the question whether the accumulations were beyond the reasonable needs of the business. To a very large degree, however, the evidence was intended to show, and did show, that irrespective of the reasonable needs of the business, the purposes of these accumulations were wholly legitimate and had no relation to surtax considerations.

The Tax Court nevertheless attempted to dispose of petitioner's evidence simply on the ground that it did not prove that the accumulations were for business needs. It completely confused the question whether there had been an accumulation beyond the reasonable needs of the business with the entirely different question as to whether or not the accumulation was made for the condemned purpose.

Similarly, the Circuit Court of Appeals referred to a number of contentions which petitioner had made before the Tax Court, including the contention that petitioner's purpose was "to enable it to meet the conditions for freeing its remaining restricted stock and the like," and stated that the Tax Court "having weighed all that against the position of the treasury that the accumulations were in excess of reasonable business needs concluded that the latter was correct" (R. 374). Here the court apparently held that the accumulation was conclusive as to purpose, even in the face of evidence completely eliminating the statutory presumption. In any event, the Circuit Court of Appeals stated that in view of "the limited scope of our power to review" it would not change the result. It did not purport to supply or dispense with the finding of fact as to purpose, essential to liability, but it failed to recognize the lack of such finding.

The Tax Court stated, and the Circuit Court of Appeals apparently concurred, that the course adopted "may have been a natural course for the majority of the stockholders to cause the corporation to adopt for their own private ends * * *" (R. 95). This being true, no liability under Section 102 was incurred, unless this course of conduct was shown to have been adopted for the condemned purpose specifically defined in the statute. Petitioner was not required under the statute to establish that the accu-

mulations were for business needs, but only that they were not motivated by surtax considerations. This the petitioner did establish, by uncontradicted and convincing proof.

The evidence before the Tax Court thus would not have supported a finding that a purpose of preventing the imposition of surtaxes on shareholders was a substantial or inducing cause of petitioner's dividend practice, even if such a finding had been made. Certainly the evidence did not compel such a finding, for it affirmatively established that the actual purposes were wholly other than avoidance of surtaxes.

The general importance of the questions presented in this case in the administration and effect of the revenue laws is apparent from the implications of the decisions below. In the first place, under the decisions the Commissioner and the Tax Court are not required to determine that the condemned purpose was an inducing, or even a contributing, cause of the accumulations, but need do no more than infer that the condemned purpose was not completely lacking. In the second place, the decision dispenses with any actual proof whatever of the condemned purpose, the Commissioner and the Tax Court being permitted to infer the existence of this absolutely indispensable fact merely from their own conclusion on the evidence as to accumulation beyond reasonable needs of the corporation and in the face of affirmative evidence to the contrary. By combining these two theories, every corporation is placed in jeopardy, and subjected to the risk of very heavy penalties in every case where there is room for difference of opinion as to the reasonable present and future needs of the business. Under the decision, knowledge on the part of directors, however well founded, that accumulation is

not motivated by surtax avoidance considerations and is motivated wholly by other legitimate purposes, is no defense to liability for a penal tax which by its terms is based solely on the existence of the surtax avoidance motive. The result is to substitute for the statutory test of liability a radically different one, vastly extending the liability, and pregnant with disastrous economic consequences.

Conclusion.

For the foregoing reasons it is respectfully submitted that the petition for writ of certiorari to the Circuit Court of Appeals for the Second Circuit should be granted.

Respectfully,

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